Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFP:CHI:1:TL-N-7390-00
JMCascino

date: May 17, 2001

to: Group Manager Jim Chmura LM:RFP 1537

from: Associate Area Counsel, (LMSB) Chicago

---

ubject: [redacted]
EIN [redacted]
Form 1065

[redacted]
SSN [redacted]
Form 1040

Taxable Year [redacted]
Earliest S.O.L. [redacted]
Request For Advisory Opinion

This memorandum responds to your written request for advice dated December 15, 2000 as supplemented by Revenue Larry Weinger's additional written request for advice dated January 9, 2001 and Mr. Weinger's oral request for additional advice received by telephone on May 15, 2001. This memorandum should not be cited as precedent. The issues herein do not appear to be within the scope of the responsibility of any Industry Counsel.

QUESTIONS PRESENTED

1. Under the facts set forth below, whether "Partners' Share of Liabilities: Other" as reported on Schedules K-1 of the U.S. Partnership Return of Income (Form 1065) of [redacted] ("[redacted]"), an Illinois limited liability company, for the taxable year [redacted] should be adjusted in any manner and whether the adjustment, if any, should be made at the partnership or partner level.

2. Under the facts set forth below, whether a loss from airplane leasing reported on [redacted]'s [redacted] Form 1065 as a trade or business loss should be recharacterized as a net rental loss from other rental activities and whether the recharacterization, if any, should be made at the partnership or partner level.

3. Under the facts set forth below, whether [redacted]'s wages deduction of $[redacted] should be disallowed in whole or in part and

whether the resulting adjustment, if any, should be made at the partner or partnership level.

4. Under the facts set forth below, whether any portion of the ($[redacted]) direct ordinary loss from [redacted] and/or any portion of the ($[redacted]) indirect ordinary loss from [redacted] through [redacted] ("[redacted]") reported by [redacted] ("[redacted]") on his U.S. Individual Income Tax Return (Form 1040) for the taxable year [redacted] should be disallowed pursuant to the provisions of I.R.C. §§ 704(d) and/or 465 and whether the adjustments, if any, should be made at the partnership or partner level.

5. Whether the ($[redacted]) direct ordinary loss from [redacted] and/or the ($[redacted]) indirect ordinary loss from [redacted] through [redacted] reported by [redacted] on his Form 1040 for the taxable year [redacted] should be recharacterized as a passive loss under I.R.C. § 469(a) on the ground that [redacted] failed to establish that he materially participated in the activities of [redacted] within the meaning of I.R.C. § 469(h) and whether the recharacterization, if any, should be made at the partnership or partner level.

CONCLUSION

1. The "Partners' Share of Liabilities: Other" as reported on Schedules K-1 of the U.S. Partnership Return of Income (Form 1065) of [redacted] for the taxable year [redacted] should be reclassified as nonrecourse through the issuance of a Notice of Final Partnership Administrative Adjustment ("FPAA") to the Tax Matters Partner ("TMP") of [redacted] for the taxable year [redacted]. The FPAA should also include an alternative determination that, if the liabilities are recourse, the liabilities are allocated [redacted]% to [redacted] and [redacted]% to [redacted].

2. The loss from airplane leasing reported on [redacted]'s [redacted] Form 1065 as a trade or business loss should be recharacterized as a net rental loss from other rental activities in the FPAA issued to the TMP of [redacted] for the taxable year [redacted].

3. [redacted]'s wages deduction of $[redacted] should be disallowed to the extent that [redacted] fails to establish that the wages paid constituted an ordinary and necessary business expense of [redacted] within the meaning of I.R.C. § 162. The resulting adjustment, if any, should be made at the partnership level only.

4. The direct ($[redacted]) ordinary loss from [redacted] and the indirect ($[redacted]) ordinary loss from [redacted] through [redacted] reported by [redacted] on his Form 1040 for the taxable year [redacted]

should be disallowed pursuant to the provisions of I.R.C. §§ 704(d) and 465 in a notice of deficiency issued to [redacted] for the taxable year [redacted].

5. The ($[redacted]) direct ordinary loss from [redacted] and the ($[redacted]) indirect ordinary loss from [redacted] through [redacted] reported by [redacted] on his Form 1040 for the taxable year [redacted] should be recharacterized as a passive loss under I.R.C. § 469(a) on the ground that [redacted] failed to establish that he materially participated in the activities of [redacted] within the meaning of I.R.C. § 469(h) and such recharacterization and any resulting adjustments made to [redacted]'s reported partnership income (loss) should be included in the notice of deficiency issued to [redacted] for the taxable year [redacted].

FACTS

[redacted] is the chief executive officer and controlling shareholder of [redacted] ("[redacted]") and [redacted] ("[redacted]"). You have orally indicated that you believe his share of both [redacted] and [redacted] was less than 80% during the taxable year [redacted], but his percentage of ownership may have increased to greater than 80% after the close of the taxable year [redacted]. [redacted] and [redacted] are subchapter C corporations engaged in the business of manufacturing, selling and leasing power generating equipment.

[redacted] ("[redacted]") is a corporation engaged in the business of manufacturing, selling and leasing [redacted] equipment to customers outside of the United States. [redacted] filed an S corporation election on [redacted] and filed S corporation returns during the years at issue. [redacted] is the sole shareholder of [redacted].

[redacted] acquired an airplane in [redacted] and periodically rented the airplane to several related companies including [redacted]. [redacted] charged the related companies $[redacted] per flight hour plus out of pocket expenses including fuel. [redacted] eventually sold the airplane during [redacted].

In late [redacted] or early [redacted], [redacted] entered into a written purchase agreement to purchase an aircraft: [redacted] ("the airplane") from [redacted] ("[redacted]"). The purchase agreement provided for a purchase price in the amount of $[redacted], an order due date of [redacted] and a preliminary delivery date of [redacted].

Minutes of the Board of Directors of [redacted] dated [redacted]

recite that it is in the interest of [redacted] to enter into a [redacted] year lease of the airplane with [redacted] at $[redacted] per month plus $[redacted] per flight hour. The minutes also stated that a $[redacted] security deposit would be due on or about [redacted]. [redacted] and [redacted] each paid a security deposit in the amount of $[redacted] to [redacted] on [redacted].

An Operating Agreement of [redacted] dated as of [redacted], was entered into by and between [redacted] and [redacted] as members of [redacted], an Illinois limited liability company ("[redacted]"). The Operating Agreement provided that [redacted] and [redacted] would contribute $[redacted] and $[redacted] to acquire [redacted] unit and [redacted] units of [redacted], respectively, and that profits and losses were to be allocated to members in proportion to the number of units of [redacted] held by each member.

The Operating Agreement provided in pertinent part:

Section 2.4 Liability to Third Parties Except as otherwise provided by the Act[1], the debts, obligations and liabilities of the Company, whether arising in contract, tort, strict liability or otherwise, shall be solely the debts, obligations and liabilities of the Company, and no Member or Manager of the Company shall be obligated personally for any such debt, obligation or liability of the Company solely by reason of being a Member or acting as a Manager of the Company.

Section 4.4 Advances Unless expressly provided in this Operating Agreement, or as otherwise agreed by the Members (a) no payment shall be made by the Company to any Member for the services of the Member, (b) no loans or advances made by the Company to any Member, and (c) no Member shall be entitled to any compensation or reimbursement from the Company or from the other Members for expenses incurred in connection with the formation, business or affairs of the Company.

Section 5.3 Liability of Members to the Company. A Member shall be liable to the Company for capital contributions as and to the extent provided by the Act.

Section 6.1 Managers. The Members may, from time to time, by unanimous agreement, vest the power to manage the business and affairs of the Company in one or more Persons, including Members...

---

[1]The "Act" means the Illinois Limited Liability Act, effective January 1, 1994 as amended from time to time.

Section 6.9 Member-Manager. The Members appoint [redacted] to be the sole Manager of the Company.

Section 7.4 Reimbursements. All of the Company's expenses shall be billed directly to and paid by the Company. The Company is specifically authorized to make reimbursements to any Member who provides goods, materials or services used for or by the Company.

Section 9.2.4 No Recourse to Assets of Members Each Member shall look solely to the assets of the Company for all distributions with respect to the Company and such Member's capital contributions thereto and share of profits or losses thereof, and shall have no recourse therefore (upon dissolution of the Company or otherwise) against any other Member.

By an Aircraft Bill of Sale dated [redacted], [redacted] assigned all of its right, title and interest in the airplane to [redacted]. Pursuant to the terms of an Aircraft Loan and Security Agreement dated [redacted] ("Loan Agreement"), [redacted] borrowed $[redacted] from [redacted] ("[redacted]"). Pursuant to the terms of the Loan Agreement, [redacted] agreed to repay the loan by [redacted] consecutive monthly payments of principal and interest in the amount of $[redacted] commencing on [redacted] and ending on [redacted] and granted [redacted] a security interest in the airplane.

[redacted], [redacted] and [redacted] each extended a written Guarantee Agreement dated [redacted] to [redacted] to guarantee the obligations of [redacted] under the Loan Agreement. Each Guarantee Agreement provided in pertinent part that:

1) In the event [redacted] did not perform its obligations for any reason, the guarantor shall pay [redacted] all amounts that [redacted] failed to pay. (See Section 1(b))

2) [redacted] could proceed to collect the entire amount due from guarantor without making any effort to collect against [redacted] or the other guarantors. (Sections 2, 4 and 5)

3) "Without limiting the generality of the waiver provisions hereof, the Guarantor hereby waives any rights to require the Secured Party ([redacted]) to proceed against the Debtor ([redacted]) or any co-guarantor or to require the Secured Party to pursue any other remedy or enforce any other right, including any and all rights under § 26-7 and § 26-9 inclusive of the

North Carolina General Statutes." (Section 2)

4) "SECTION 3. No Subrogation. Notwithstanding anything to the contrary in this Guarantee, the Guarantor hereby irrevocably waives all rights which may have arisen in connection with this Guarantee to be subrogated to any of the rights (whether contractual, under the Bankruptcy Code, including Section 509 thereof, under the common law or otherwise) of the Secured Party against the Debtor or against any collateral security or guarantee or right of offset held by the Secured Party for the payment of the Obligations. The Guarantor hereby further irrevocably waives all contractual, common law, statutory or other rights of reimbursement, contribution, exoneration, or indemnity (or similar right) from or against the Debtor or any other party which may have arisen in connection with this Guarantee. So long as the Obligations remain outstanding, if any amount shall be paid by or on behalf of the Debtor to the Guarantor on account of any of the rights waived in this paragraph, such amount shall be held by the Guarantor in trust, segregated from other funds of such Guarantor, and shall, forthwith upon receipt by such Guarantor, be turned over to the Secured Party in the exact form received by the Guarantor (duly indorsed by the Guarantor to the Secured Party, if required), to be applied against the Obligations, whether matured or unmatured, in such order as the Secured Party may determine. The provisions of this paragraph shall survive the termination of this Guarantee and the payment in full of the obligations."

Aircraft Lease Agreements dated [redacted] were entered into by and between [redacted] and [redacted] ("[redacted] Lease"), [redacted] and [redacted] ("[redacted] Lease") and [redacted] and [redacted], an unrelated party, ("[redacted] Lease") for the lease of the airplane. The term of the [redacted] Lease and [redacted] Lease was each [redacted] years. The term of the [redacted] Lease was [redacted] year. Section III of The [redacted] Lease and of the [redacted] Lease was entitled "RENT" and provided for payments by the lessee ([redacted] or [redacted]) to the lessor ([redacted] of $[redacted] per month, $[redacted] per flight hour, the cost of a two man crew to be supplied by the lessor (no amount specified in the agreement), the cost of fuel, maintenance insurance and other reasonable costs incurred by the lessor and a [redacted] non-interest baring security deposit. Section III of [redacted] was also entitled "RENT" and provided for payments by the lessee ([redacted]) to the lessor ([redacted]) of $[redacted] per flight hour and $[redacted] for a two man crew to be supplied by the lessor on days the airplane was chartered.

Although the Operating Agreement establishing [redacted] was dated as of [redacted], on its Forms 1065 for the taxable years

[redacted] and [redacted], [redacted] listed the date its business started as [redacted]. On its [redacted] and [redacted] Forms 1065, [redacted] listed both its principal business activity and principal product or service as "Chartering Airplane" and it business code number as "[redacted]" (Other passenger transportation).

A small loss was claimed on [redacted]'s [redacted] return and not adjusted. The I.R.C. § 6229 statute of limitations has expired with respect to the [redacted] taxable year of [redacted].

On page one of its [redacted] Form 1065, [redacted] reported the following:

Gross receipts	$[redacted]
Total Income	[redacted]
Salaries	[redacted]
Taxes and licenses	[redacted]
Depreciation	[redacted]
Other Deductions	[redacted]
Total Deductions	[redacted]
Ordinary loss	([redacted])

The other deductions included interest expense of $[redacted], fuel expense of $[redacted], pilot expense of $[redacted], co-pilot expense of $[redacted] and various other expenses. Your examination of the cash receipts and disbursements journal of [redacted] indicated that the checks for pilot expense were issued to [redacted] and that the checks for co-pilot expense were issued to the co-pilot. You also indicated that the pilot had a desk at [redacted] during the [redacted] taxable year and that you believe that the pilot was paid as a W-2 employee of [redacted] for the taxable year [redacted] and was paid as a W-2 employee of [redacted] or [redacted] in prior years.

Consistent with the terms of the Operating Agreement, the [redacted] ordinary loss is allocated [redacted]%($[redacted]) to [redacted] and [redacted]% ($[redacted]) to [redacted] on Schedules K-1 of [redacted]'s [redacted] Form 1065. Various other items such as portfolio interest, dividends and capital gains are also allocated [redacted]% to [redacted] and [redacted]% to [redacted] on Schedules K-1. Partner's share of liabilities: other on Schedule K-1, Box F are also allocated [redacted]% ($[redacted]) to

[redacted] and [redacted]% ($[redacted]) to [redacted].

The analysis of the partners' capital accounts on Schedules K-1 of [redacted]'s Form 1065 reports the following:

Partner	Begin.	Contr.	Lines 3,4,7 Sch M-2	Distr.	Ending
[redacted]	([redacted])	[redacted]	([redacted])	[redacted]	([redacted])
[redacted]	([redacted])	[redacted]	([redacted])	[redacted]	([redacted])

You have indicated that you do not know why [redacted] received a distribution of $[redacted]. The ending balance sheet on Schedule L of [redacted]'s [redacted] Form 1065 reports a Due From Partner amount of $[redacted].

Although the instructions for the [redacted] Form 1120S state that ordinary income (loss) from trade or business activities of a partnership should be reported as "Other Income" on Line 5 of page one of [redacted] Form 1120S, [redacted] reported the ordinary loss set forth on its Schedule K-1 from [redacted] as "Income (Loss) From Other Rental Activities", a separately stated item. [redacted] combined its ($[redacted]) loss from [redacted], net rental income of $[redacted] from "[redacted] Equipment" and a $[redacted] Form 4797 gain from the sale of a [redacted] car to arrive at a net loss from other rental activity in the amount of ($[redacted]) which amount was also reported on the [redacted] Schedule K-1 issued to [redacted]. [redacted] also reported net ordinary income on page one of [redacted] Form 1120S in the amount of $[redacted] which amount was also reported on the [redacted] Schedule K-1 issued to [redacted]. Other items such portfolio interest, dividends, capital gains and tax preference items were also reported on the [redacted] [redacted] Schedule K-1 issued to [redacted].

On his [redacted] Form 1040, [redacted] reported his direct [redacted]% share of the ordinary loss from [redacted] of ($[redacted]) as a trade or business - material participation non-passive loss. However, [redacted] reported that $[redacted] of the [redacted] ordinary loss was disallowed due to at-risk. Accordingly, [redacted] deducted only $[redacted] of the direct [redacted] ordinary loss as a non-passive loss, an amount equal to the portfolio interest, dividends and capital gain which he also reported from his direct interest in [redacted]. With respect to [redacted]'s share of the ordinary loss of [redacted] through [redacted], [redacted] combined the $[redacted] ordinary income amount and ($[redacted]) net loss amount from other rental activities set forth on his [redacted] Schedule K-1 from [redacted] and reported a net nonpassive loss from [redacted] from trade or business - material participation in the amount of ($[redacted]).

The [redacted] taxable years of [redacted] and [redacted] are currently under audit by Revenue Agent Larry Weinger. A Notice of Beginning of Administrative Proceedings ("NBAP") has been issued to the partners of [redacted] for the taxable year [redacted]. The I.R.C. § 6229 period of limitations for [redacted]'s taxable year [redacted] and the I.R.C. § 6501(a) period of limitations for [redacted]'s taxable year [redacted] will both expire on [redacted]. Based upon your previous dealing with [redacted], you believe that it is unlikely that [redacted] would consent to an extension of either period of limitations.

[redacted] was involved in prolonged Tax Court litigation in the audit of two of his corporations and his individual returns for prior cycles. After initially responding to some of the information document request ("IDRs")issued to [redacted] and [redacted] by Mr. Weinger, [redacted] individually and as TMP of [redacted] became uncooperative with respect to the audit his individual [redacted] return of [redacted] and [redacted]'s [redacted] return. [redacted] and [redacted] failed to respond to IDRs regarding how the "Partner's share of liabilities: Other" shown on each [redacted] Schedule K-1 was arrived at; whether there is any agreement between the co-guarantors of [redacted]'s liabilities with respect to order of payment or reimbursement; and the nature and extent of [redacted]'s activities in connection with [redacted]. [redacted] also refused to be interviewed in connection with these matters.

[redacted] was not a pilot. During [redacted] he was a CEO of [redacted] and [redacted].

During the audit Mr. Weinger contacted two third party aircraft lessors who stated to Mr. Weinger that the fair market rental value of the airplane is approximately [redacted]% of the capital cost of the airplane or approximately $[redacted] per month. The third party aircraft lessors also stated to Mr. Weinger that the flight hours and days used by [redacted] and [redacted] were normal. The third party aircraft lessors observed that they have seen executives commonly lease jets back to corporations for investment purposes and for tax purposes to take advantage of depreciation. One of the third party lessors indicated that an airplane is usually a good investment because it can be sold in five years for approximately 93% of its original cost. Based upon this information, you have determined not to raise any adjustments under I.R.C. § 162, 183 or 482 with respect to the lease agreements.

The Forms 1120 of [redacted] and [redacted] for the taxable years

ended [redacted] and [redacted] were audited by Mr. Weinger and closed agreed. One of the agreed adjustments in each case was imputed interest under I.R.C. § 7872 for the non-interest baring security deposits referred to above. Deductions for the rental payments by [redacted] and [redacted] to [redacted] were allowed as claimed.

On May 15, 2001, you orally indicated to our office that you discovered that the wages deduction of $[redacted] claimed on [redacted]'s [redacted] return represented W-2 wages in the amount of $[redacted] paid to two [redacted]. Pursuant to our oral advice, you indicated that you would issue a written request for an explanation of the nature and extent of the services performed by these [redacted] on behalf of [redacted] during the [redacted] taxable year. If a satisfactory response is not received within ten days, you intend to disallow the wages deduction in full for lack of substantiation.

DISCUSSION

1. The instructions to Schedule K-1 of [redacted] Form 1065 state that in pertinent part,

> "Nonrecourse liabilities" are those liabilities of the partnership for which no partner bears the economic risk of loss. The extent to which a partner bears the economic risk of loss is determined under the rules of Regulations section 1.752-2.....
>
> The at-risk rules of section 465 generally apply to any activity carried on by the partnership as a trade or business or for the production of income. These rules generally limit the amount of loss and other deductions a partner can claim from any partnership activity to the amount for which that partner is considered at risk.

Treasury Regulation § 1.752-1(a)(1) states that a partnership liability is a recourse liability to the extent any partner or related person bears the economic risk of loss for that liability under Treas. Reg. § 1.752-2. A "related person" means a person having a relationship to a partner that is described in Treas. Reg. § 1.752-4(b). Under Treas. Reg. § 1.752-4(b) a person is related to a partner if the person and the partner bear a relationship to each other that is specified in sections 267(b) or 707(b)(1) except substituting 80% for 50% each place it appears in those sections. Under Treas. Reg. § 1.752-4(b)(2)(iii), persons owning interests directly or indirectly in the same partnership are not treated as related

persons for purposes of determining the economic risk of loss borne by each of them for the liabilities of the partnership.

Under Treas. Reg. § 1.752-2(a) a partner's share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person bears the economic risk of loss. The determination of the extent to which a partner bears the economic risk of loss for a partnership liability is made under the rules in paragraphs (b) through (j) of this section.

Under Treas. Reg. § 1.752-2(b)(1), except as otherwise provided in said section, a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership is constructively liquidated, the partner or related person would be obligated to make a payment to any person because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner. Under Treas. Reg. § 1.752-2(b)(3), all contractual obligations relating to the partnership liability, including contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements and other obligations running directly to creditors or other partners or to the partnership, undertaken by the partner or related person are taken into account to determine whether the partner bears the risk of loss.

Under Treas. Reg. § 1.752-2(b)(4), a payment obligation is disregarded if, taking into account all the facts and circumstances, the obligation is subject to contingencies that make it unlikely that the obligation will ever be discharged.

In this case, by reporting the partners' share of partnership liabilities as "Partner's share of liabilities: Other" on Schedule K-1, Box F, [redacted]% ($[redacted]) to [redacted] and [redacted]% ($[redacted]) to [redacted], [redacted] has classified all of the partnership liabilities as recourse with [redacted]% allocated to [redacted] and [redacted]% allocated to [redacted]. Although Mr. Weinger requested information as to whether there was any agreement among the co-guarantors as to reimbursement, neither [redacted] nor [redacted] responded to Mr. Weinger's request for information. If there was an agreement that [redacted] and/or [redacted] would pay the guarantee and/or reimburse [redacted], none of the partners of [redacted] would bear the economic risk of loss within the meaning of Treas. Reg. §§ 1.752-1 and 1.752-2. Accordingly, in our view, [redacted] has not established that the liabilities reported on [redacted] Schedule K-1s were recourse liabilities within the meaning of Treas. Reg. § 1.752-1 and we recommend that an FPAA be issued to the TMP of [redacted]

which includes a determination that:

> You have failed to establish that the liabilities shown on Schedules K-1 of the your return are other than nonrecourse liabilities. Accordingly, it is determined that the liabilities shown on the Schedules K-1 of said return are nonrecourse liabilities.

Alternatively, if [redacted] has correctly treated the liabilities as recourse, in our view, [redacted] has incorrectly allocated said liabilities. As is discussed below, to the extent the liabilities are recourse, all of the liabilities should be allocated to [redacted].

Under Sections 2.4 and 5.3 of the Operating Agreement, the members of [redacted] were not liable for debts of the partnership in excess of their required capital contributions to [redacted]. However, [redacted] executed a guarantee of [redacted]% of the partnership's liability to [redacted] which guarantee is taken into account in determining his share of the liabilities of [redacted]. Treas. Reg. § 1.752-2(b)(3). [redacted] did not execute a guarantee of this liability. Although [redacted] and [redacted] are related ([redacted] owns [redacted]% of [redacted]), [redacted] and [redacted] are not treated as related persons for purposes of determining the economic risk of loss borne be each of them for the liabilities of [redacted]. Treas. Reg. § 1.752-4(b)(2)(iii). Therefore, [redacted]'s guarantee of [redacted]'s liability is not attributable to [redacted] and no portion of [redacted]'s liability should be allocated to [redacted].

Since [redacted] has guaranteed [redacted]% of [redacted]'s liability, he should be allocated [redacted]% of [redacted]'s liability unless he is entitled to reimbursement from another partner or person that is related to another partner. Treas. Reg. § 1.752-2(b)(1). In this case, pursuant to Sections 4.4 and 9.2.4 of the Operating Agreement, [redacted] is not entitled to reimbursement from [redacted], the only other partner of [redacted]. Although Section 3 of [redacted]'s guarantee states that [redacted] is not entitled to reimbursement from "any other party", [redacted]'s co-guarantors, [redacted] and [redacted], are not parties to [redacted]'s guarantee which runs to [redacted]. Thus, if [redacted] paid on his guarantee, he could potentially be entitled to reimbursement from co-guarantors, [redacted] and [redacted]. However, since [redacted] owns less than 80% of both [redacted] and [redacted], neither [redacted] nor [redacted] are "related" to "[redacted]" under Treas. Reg. § 1.752-2(b)(1). Treas. Reg. § 1.752-4(b)(1). Since [redacted] and [redacted] are not related to [redacted], [redacted] is not entitled to reimbursement from another partner or person that is related to another partner and, therefore, bears the risk of loss with respect to [redacted]% of the liability under Treas. Reg. § 1.752-2(b)(1) and should be allocated [redacted]% of the liability

under Treas. Reg. § 1.752-2(a). Accordingly, we recommend that the FPAA include an alternative determination that:

> Alternatively, to the extent that liabilities shown on Forms K-1 of said return are recourse, [redacted]% of said liabilities are allocable to partner [redacted] and no portion of said liabilities are allocable to partner [redacted].

2. In the case of an individual, a passive activity loss is not allowable for any taxable year. I.R.C. § 469(a). The term "passive activity" means any activity which involves the conduct of a trade or business and in which the taxpayer does not materially participate. I.R.C. § 469(c)(1). Except with respect to certain real estate activities described in I.R.C. § 469(c)(7), the term "passive activity" includes any rental activity without regard to whether or not the taxpayer materially participates in the rental activity. I.R.C. § 469(c)(2) and (c)(4).

The term "rental activity" means any activity where payments are principally for the use of tangible property. I.R.C. § 465(j)(8). Except as otherwise provided in Prop. Treas. Reg. § 1.469-1T(e)(3), an activity is a rental activity for a taxable year if (1) tangible property held in connection with the activity is used by or held for use by customers and (2) the gross income from the activity represents amounts paid, or to be paid, principally for the use of such property. Temp. Reg. § 1.469-1T(e)(3)(i).

An activity involving the use of tangible property is not a rental activity for a taxable year if for the taxable year extraordinary personal services (within the meaning of Temp. Reg. § 1.469-1T(e)(3)(v)) are provided by or on behalf of the owner of the property in connection with making such property available for use by customers (without regard to the average period of customer use). Temp. Reg. § 1.469-1T(e)(3)(ii)(C).

For purposes of Temp. Reg. § 1.469-1T(e)(3)(ii)(C), extraordinary personal services are provided in connection with making property available for use by customers only if the services provided in connection with the use of the property are performed by individuals, and the use by customers of the property is incidental to their receipt of such services. For example, the use by patients of a hospital's boarding facilities generally is incidental to their receipt of the personal services provided by the hospital's medical and nursing staff. Similarly, the use by students of a boarding school's dormitories generally is incidental to their receipt of the personal services provided

by the school's teaching staff. Temp. Reg. § 1.469-1T(e)(v).

Temporary Regulation § 1.469-1T(e)(3)(viii) provides several examples to illustrate the operation of Temp. Reg. § 1.469-1T(e)(3). In Example (3), the taxpayer is engaged in an activity of transporting goods for customers. In conducting the activity, the taxpayer provides tractor-trailers to transport goods for customers pursuant to arrangements under which the tractor-trailers are selected by the taxpayer, may be replaced at the sole option of the taxpayer, and are operated and maintained by drivers and mechanics employed by the taxpayer. The average period of customer use for the tractor-trailers exceeds 30 days. Under these facts, the use of tractor-trailers by the taxpayer's customers is incidental to their receipt of personal services provided by the taxpayer. Accordingly, the services performed in the activity are extraordinary personal services (within the meaning of Temp. Reg. § 1.469-1T(e)(3)(v)) and, under Temp. Reg. § 1.469-1T(e)(3)(ii)(C), the activity is not a rental activity.

In Frank v. Commissioner, T.C. Memo. 1996-177, the taxpayer leased an airplane to a lessee that subleased the airplane to customers who were learning to fly. The lessee paid the taxpayer for use of the airplane, held the airplane for use by customers, and paid for fuel, oil maintenance, inspection fees, insurance, and parts. Taxpayer, with a mechanic, changed the airplane's oil, removed screws from the inspection plate, and tied down and washed the airplane. The Tax Court held that the taxpayer's losses from its airplane leasing activity are passive losses because services rendered to the lessee were not the dominant element of the relationship between the taxpayer and lessee. See also Kenvill v. U.S., 97-2 USTC para. 50,936 (USDC 1997).

In TAM 199949036, the national office concluded that the losses incurred by an S corporation in 1994 and 1995 resulting from its airplane transportation activity were not losses from a rental activity because the services of the S Corporation in operating and maintaining the airplane and providing pilots to transport the personnel of the other party to a "jet use Agreement" constituted extraordinary personal services within the definition of section 1.469-1T(e)(3)(ii)(C) of the temporary regulations. In our view, TAM 19949036 is distinguishable from the case herein. Although the lease agreements provide that [redacted] will supply a two-man crew, the cash disbursements ledger of [redacted] shows that [redacted]'s pilot expense payments were made to [redacted] and Mr. Weinger has indicated that it appears likely that the pilot was a W-2 employee of [redacted] during the [redacted] taxable year at issue. Unlike the facts in TAM 199949036, the pilot herein was an employee of one of the lessees. Therefore, [redacted] has not provided extraordinary personal services within the definition of

section 1.469-1T(e)(3)(ii)(C) of the temporary regulations and [redacted] has incorrectly reported its airplane leasing activity as a trade or business activity rather than a rental activity. In addition, [redacted] reported its loss from [redacted] as a loss from other rental activities. Accordingly, we recommend that the FPAA include the following determination:

> It is determined that you incorrectly reported your principal business activity as "Chartering Airplane", you incorrectly reported your principal product or service as "Chartering Airplane", you incorrectly reported your Business Code number as [redacted] and you incorrectly reported your loss from said activity as ordinary income (loss) from trade or business activities. It is determined that your principal business activity is "Equipment rental and leasing", your principal product is "Airplane leasing", your Business Code number is [redacted], your ordinary loss from trade or business activities is [redacted] and the partners' distributive shares of net income (loss) from other rental activities is ($[redacted]).
>
> Accordingly, your ordinary loss from trade or business activities is reduced from ($[redacted]) to [redacted] and the partners' distributive shares of net income (loss) from other rental activities is increased to ($[redacted]).

3. Under I.R.C. § 162, a deduction is allowed for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business including, but not limited to, a reasonable allowance for salaries or other compensation for personal services actually rendered. In this case, [redacted] has claimed a wages deduction in the amount of $[redacted] for wages paid to two [redacted]. You indicated that you would issue a written request for an explanation of the nature and extent of the services performed by these [redacted] on behalf of [redacted] during the [redacted] taxable year. If a satisfactory response is not received within ten days, you intend to disallow the wages deduction in full for lack of substantiation. We agree with this approach. To the extent that [redacted] fails to substantiate that the wages deduction represents an ordinary and necessary business of expense of [redacted], we recommend that the FPAA include a disallowance of this deduction. The notice of deficiency should not include this adjustment.

4. A partner's distributive share of partnership loss shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. I.R.C. § 704(d).

In the case of an individual engaged in a trade or business or other activity engaged in for the production of income, any loss from the activity for the taxable year is allowed only to the extent of the aggregate amount with respect to which the taxpayer is at-risk for such activity at the close of the taxable year. I.R.C. § 465(a)(1)and (c)(3). A taxpayer is considered at-risk for an activity with respect to amounts including the amount of money and the adjusted basis or other property contributed by the taxpayer to the activity and amounts borrowed with respect to such activity for which the taxpayer is personally liable for repayment. I.R.C. § 465(b)(1) and (b)(2). Prop. Treas. Reg. § 1.465-24(a)(1). When a partnership incurs a liability and under state law, members of the partnership may be held personally liable for repayment of the liability, each partner's amount at-risk is increased to the extent the partner is not protected against loss. Prop. Treas. Reg. § 1.465-24(a)(2)(i).

If a taxpayer guarantees repayment of an amount borrowed by another person (primary obligor) for use in an activity, the guarantee shall not increase the taxpayer's amount at risk. If the taxpayer repays the creditor the amount borrowed by the primary obligor, the taxpayer's amount at risk shall be increased at such time as the taxpayer has no remaining legal rights against the primary obligor. Prop. Treas. Reg. § 1.465-6(d).

A guarantor of a partnership liability is not at-risk for purposes of I.R.C. § 465 to the extent the guarantor has a right of reimbursement against any partner. Brand v. Commissioner, 81 T.C. 821 (1983). On the other hand, if a partner undertakes a contractual obligation by which the partner bears the ultimate responsibility for repayment of the obligation (meaning the partner is personally liable for repayment and not entitled to reimbursement from another), the partner is considered to be at-risk within the meaning of I.R.C. § 465 with respect to the amount of the obligation. Pritchett v. Commissioner, 827 F. 2d 644 (9th Cir. 1987), rev'g and remanding 85 T.C. 580 (1985); Gefen v. Commissioner, 87 T.C. 1471 (1986); Abramson v. Commissioner, 86 T.C. 360 (1986). Melvin v. Commissioner, 88 T.C. 63 (1987) aff'd 894 F. 2d 1072 (9th Cir. 1990); Bennion v. Commissioner, 88 T.C. 684 (1987).

a. [redacted]'s direct [redacted]% interest in [redacted]

As the facts indicate, [redacted] was allocated ($[redacted]) or [redacted]% of the ordinary loss of [redacted], but on his Form 6198 of his Form 1040, [redacted] reported that he was not at risk as to ($[redacted]) of said loss and deducted only ($[redacted]) of said loss, an amount equal to the total of the portfolio interest, dividends and short

term gain of $[redacted], $[redacted] and $[redacted], respectively, shown on his [redacted] Schedule K-1. However, because the [redacted] Schedule K-1 issued to [redacted] shows a negative year end capital account balance of ($[redacted]) and [redacted]'s share of liabilities is only $[redacted], [redacted] did not have sufficient basis or at risk amount to deduct any loss from his direct interest in [redacted] for the taxable year [redacted]. Accordingly, the notice of deficiency should include a determination that [redacted]'s claimed loss from [redacted] is disallowed because [redacted] failed to establish that he had sufficient basis to deduct the loss and failed to establish that he was at risk with respect to the loss.

b. [redacted] indirect interest in [redacted] through [redacted]

Whether [redacted] had sufficient basis to deduct his claimed loss from [redacted] through [redacted] will depend in part on determinations to be made in the partnership proceeding involving [redacted]. As the facts indicate, [redacted] treated the partnership liabilities as recourse and allocated [redacted]% of said liabilities to [redacted]. We have recommended in Section 1 above that an FPAA be issued to [redacted] which determines that the liabilities shown on the Schedules K-1 issued to the partners of [redacted] are nonrecourse. If the liabilities are nonrecourse, the allocation of [redacted]% of said liabilities to [redacted] was proper because the allocation was in accordance with [redacted] share of profits and the liabilities would be included in basis under Treas. Reg. §§ 1.752-3, 1.752-1(b) and I.R.C. § 722. [redacted] and [redacted] would have sufficient basis to claim the loss. However, if it is determined that the liabilities are recourse and allocated to [redacted], then [redacted] would be allocated no share of the liabilities and have insufficient basis to claim any loss from [redacted] under I.R.C. § 704(d). Since [redacted] share of the loss would be reduced to [redacted], [redacted]'s share of said loss through [redacted] would also be reduced to [redacted] under I.R.C. § 704(d). While this basis determination is dependent on partnership level determinations, the basis determination also involve partner level determinations. Accordingly, we recommend that the notice of deficiency include a determination that [redacted]'s claimed loss from [redacted] through [redacted] is disallowed because [redacted] failed to establish he had sufficient basis to deduct the loss.

As discussed in section 1. herein, although Mr. Weinger requested information as to whether there was any agreement among the co-guarantors as to reimbursement, neither [redacted] nor [redacted] responded to Mr. Weinger's request for information. Accordingly, in our view, [redacted] has not established that he was at risk with respect to the loss claimed from [redacted] through [redacted] because he failed to establish that he was not protected against loss, within the meaning of I.R.C. § 465(b)(4), by the guarantees

executed by [redacted] and [redacted]. In the notice of deficiency to be issued to [redacted], we recommend that the loss claimed by [redacted] from [redacted] through [redacted] in the amount ($[redacted]) should also be disallowed on the ground that [redacted] failed to establish that he was at risk with respect to said loss.

5. As the facts indicate, neither [redacted] nor [redacted] provided any substantiation that either materially participated in [redacted] within the meaning of I.R.C. § 469(h). Accordingly, we recommend that the notice of deficiency issued to [redacted] include a determination that the direct loss from [redacted] and indirect loss from [redacted] through [redacted] are passive losses within the meaning of I.R.C. § 469(a) because [redacted] failed to establish that he materially participated in the activities of [redacted] within the meaning of I.R.C. § 469(h). This disallowance involves strictly a partner level determination and should only be included in the notice of deficiency to be issued to [redacted] and should not be included in the FPAA to be issued to the tax matters partner of [redacted]. I.R.C. § 6231(a)(3); Treas. Reg. § 301.6231(a)(3)-1.

In accordance with LMSB procedures, we are submitting this advisory opinion for review by our National Office and anticipate a response from the National Office in approximately ten days. As you know the response can supplement, modify and/or reject the advice contained herein. Accordingly, please take no action on the advice contained herein until such time as we notify you as to whether or not there are any exceptions or modifications to the advice contained herein as a result of the response received from the National Office.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions concerning this matter, please do not hesitate to call me at (312) 886-9225 ext. 338.

PAMELA V. GIBSON
Associate Area Counsel

By:_____
JAMES M. CASCINO
Attorney

cc: Barbara B. Franklin
Daniel F. Carmody
Pamela V. Gibson
Harmon B. Dow
William G. Merkle